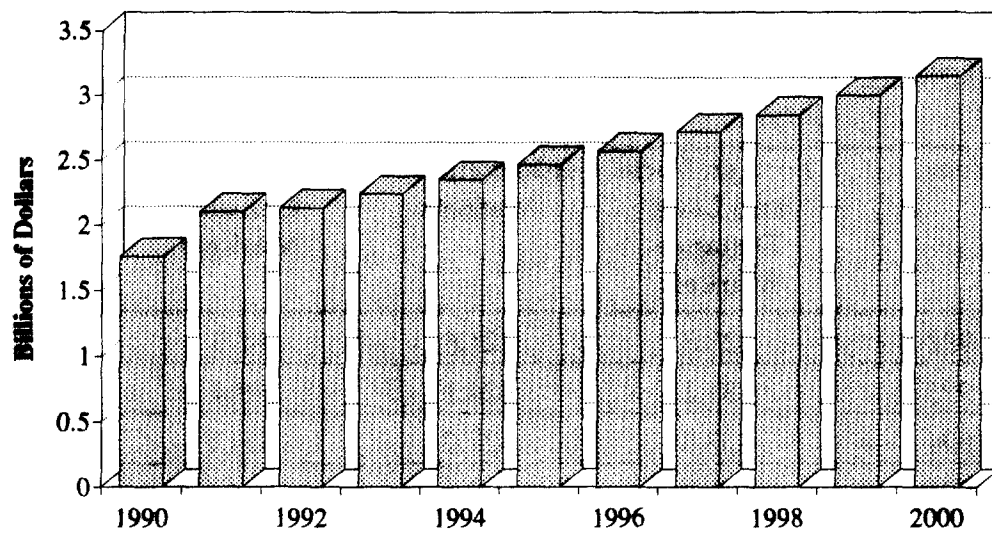


**Figure 4.3: Non-Cost-Based Overpayments by U.S. Consumers to Foreign Firms via the Accounting Rate System.** Source: Economic Strategy Institute.



**Cumulative U.S. Loss: \$27.34 billion**

### **Conclusion**

*Foreign government regulations and international agreements that hamper the ability of U.S. firms to take advantage of their competitive advantage in global telecom markets have a significant impact on the U.S. economy.*

The consequences of foreign regulatory barriers are sobering. Each year billions of dollars are extracted from U.S. consumers, and U.S. firms are denied billions of dollars of revenue that would be repatriated to strengthen the U.S. economy. These regulations also ensure that foreign firms keep 100 percent of overseas markets and gain a piece of the U.S. multinational services market at the expense of more efficient U.S. firms. Many of the proposed deregulation plans will fail to open up significant opportunities for U.S. firms in the short-run and will continue to keep U.S. firms at a disadvantage in the long-run. Therefore, the United States government must take an aggressive role in negotiating the elimination of barriers to U.S. investment in foreign telecom markets and the revision of the accounting rate system.

## CHAPTER V: RECOMMENDATIONS

### *Promoting Competitiveness, Opening Foreign Markets, and Improving Consumer Welfare*

#### **A. Promoting Competitiveness through Domestic Deregulation**

Regulation has failed to keep pace with the technological change that is revolutionizing telecommunications. As technology has increased the versatility of telecommunications networks, there has been a blurring of the roles of these networks; yet the regulatory environment has maintained an outmoded distinction between each industry. For instance, although local telephone companies have the potential to provide video programming, they are prevented from entering this market due to regulatory constraints. This outdated regulatory regime is delaying the advent of a ubiquitous, competitive information infrastructure and costing consumers billions of dollars annually.

Any restructuring of the domestic regulatory environment will have a profound impact on the international competitiveness of U.S. firms. By creating an environment that promotes competition and constant productivity improvements, the United States can not only improve the international competitiveness of U.S. telecom services firms but also maximize U.S. consumer savings, promote higher quality services, and spur innovation. Domestic deregulation should therefore incorporate two principles:

- Promote competition in all telecom services sectors
- Create incentives for telecom service providers to become more efficient

Congress should also investigate the potential for overinvestment in the local exchange before moving forward with deregulation. The following is an examination of these principles and a discussion of their impact on international competitiveness and opportunities for U.S. firms overseas.

### 1. Promoting Competition

Domestic competition is one of the most important factors in promoting international competitiveness.<sup>136</sup> The McKinsey Global Institute found, in a study of service sector productivity, that competition and rules regarding firm concentration were significant factors in promoting labor productivity. In fact, the study concluded that "Openness to competition is the most important factor in the productivity difference between service industries in Europe, Japan, and the United States."<sup>137</sup> More specifically, the study found that...

"Public policy exerts its greatest influence on productivity through the competition and concentration rules that operate at country or industry level. Among the various competition rules, the most important are those that help or hinder the freedom to enter a market and to offer services at unrestricted prices. Whenever we observed regulatory interference with one of the basic market elements --freedom of entry and pricing -- the affected industry seemed to pay for the interference with lower levels of productivity."<sup>138</sup>

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<sup>136</sup>There are several other ways U.S. regulatory bodies can promote international competitiveness. The success of the cellular industry in foreign markets is a direct result of the FCC's speed in allocating frequency licenses. This allowed U.S. firms to gain important technical experience in the sector before their international competitors. Allowing trial demonstrations of new technologies or combining technologies is also critical to competitiveness. Unfortunately, the FCC's spectrum allocation for PCS systems (being auctioned in December 1994) is behind allocation in several key foreign markets, and this factor may disadvantage U.S. firms when bidding for PCS systems in foreign nations.

<sup>137</sup>The McKinsey Global Institute, "Service Sector Productivity and International Competitiveness," *The McKinsey Quarterly*, Volume No. 2, 1992, p. 89

<sup>138</sup>*Ibid.*, p.77.

The current regulatory regime restricts competitive forces by maintaining outdated distinctions between different sectors of the Industry. Although U.S. consumers and firms benefit from having one of the world's most competitive long distance markets, the monopolistic local exchange and the duopoly in cellular services promote higher costs that impede U.S. international competitiveness. Enhanced, fair telecom competition would produce significant benefits for every sector of the U.S. economy. Annual consumer savings could exceed billions of dollars as intra-lata, cellular, and cable costs decline. This nationwide cost reduction would also check inflationary pressures. Increased competition is also seen by the overwhelming majority of analysts as key to accelerating the national information superhighway's development, spurring product innovation, and improving service quality. Clearly, promoting competition in the domestic market is in the best interest of the United States.

For competitive reasons, as well as overinvestment concerns, every firm that has the capacity (or desire) to provide telecom services must be afforded the opportunity to do so. Currently, in some areas, there are up to eight networks with the capacity to carry telecom traffic, such as cable, electric utility, Internet, and various wireless networks, in addition to telephone networks. The owners of these networks, several of which operate as monopolies in their core business, must be restricted from using their monopoly power to deter competition and from cross-subsidizing their telecom services operations. While fears of monopoly power abuse are justified, it is important to remember that the FCC has had significant experience overseeing firms with dominant market power and, with the appropriate guidance and authority from Congress, is fully capable of sustaining a competitive market environment. Table 5.1 offers a quick glance at a few of the most common networks that can and should be allowed to carry various telecom services traffic.

**Table 5.1: Potential Full-Service Telecom Networks.** Source: Economic Strategy Institute.

Type of Network	Network Characteristics	Current Regulations
Cable TV	Cable TV networks differ significantly from the traditional telephone network. Cable networks are one-way, non-switched systems (telephone networks are two-way, switched) operating on broadband lines (coax and fiber). These networks reach about 70 percent of all homes, and therefore, many long distance companies are actively seeking to invest in cable franchises.	The cable television industry is characterized by many regional monopoly providers. Cable companies are allowed to operate networks in competition with other cable networks if authorized by the local franchising authority. They are currently subject to the same regulatory barriers to local competition faced by other firms.
Electric Utility Companies	Electric utility companies operate their own telecom networks to monitor their electricity transmission systems, as well as to provide internal communications. Since these are fiber optic and coaxial cable networks, their capacity far exceeds what is being used by the electric utility firms, <sup>139</sup> leading some utility companies to seek permission to use this excess capacity for additional telecom services.	At present, municipally-owned electric utilities are allowed to operate telecom networks. Not all electric utilities are permitted to enter the telecom services market, however. Specifically, the nine largest utility companies (known as registered holding companies) are prohibited by the Public Utility Holding Company Act of 1935 from providing telecom services.
The Internet	The Internet was built in 1969 to link researchers across the country to remote computer centers, providing access to hardware and software resources. Over time the Internet grew to provide access to academic institutions, and more recently it was made available to business users. The Net now connects thousands of companies, enabling information exchange and access to scientific research. <sup>140</sup>	The Internet poses a strategic threat to other telecom providers since it has the capacity to provide competitive telecom services. <sup>141</sup> This potential will be greatly improved as personal computers become more widespread and households gain broadband access to the Internet.

It is also important that U.S. resources and capital are used efficiently. If regulations restrict existing infrastructure from being upgraded, a competing

<sup>139</sup>In fact, as much as 98 percent of their fiber optic capacity remains unused.

<sup>140</sup>The Internet has experienced enormous growth in recent years: it has grown at a rate of 15 percent per month over the past five years and now reaches 20 million computers. (Source: George Gilder, "Breaking the Box," *National Review*, 15 August 1994, p. 38.)

<sup>141</sup>Robert B. Cohen, "The Economics of Electronic Superhighways" (paper presented to the 15th International Conference of IDATE, Montpellier, France, 24 November, 1993), p. 8-11.

network will be built less efficiently (i.e. The costs of constructing a new network are greater than upgrading and utilizing many of the existing networks.) Regulations should therefore not discriminate among potential telecom providers.

## 2. Creating Incentives to Promote Efficiency

Government must always be watchful of a firm operating in a non-competitive market. The government can use two primary tools to control a monopoly's costs: rate of return regulations, stipulating the profit margin of a firm, and price caps, stipulating the price a firm may charge. Price caps encourage firms to lower their costs in order to increase profits, while rate of return regulations guarantee the same profit margin regardless of cost. (i.e. There is no incentive to become more efficient.) If the United States wants to foster greater efficiency and competitiveness in U.S. firms, the government should replace rate of return regulations with price caps.

### *The Overinvestment Question*

To date, no serious research of the potential for overinvestment in the local exchange has been publicly criticized or debated. Although one might assume an entirely competitive telecom infrastructure always maximizes efficiency, this may not be true. While costs at the center of the network are low enough to justify competition, as one moves incrementally further from the core, the costs-per-subscriber increase, because the costs are shared among less people. Cable at the center of the network is used by thousands of households while a cable at the periphery is used only by one household.<sup>142</sup> Therefore, to provide service to all customers, more cable must be laid at the periphery than at the center.<sup>143</sup> As the local exchange becomes gradually more competitive, and costs of duplicating each additional increment increases, the cost efficiencies generated by a competitive market may no longer justify the construction of a competitive alternative. Congress, and other regulatory bodies, may wish to examine this

<sup>142</sup>In fact, the local loop (the part of the network that connects homes and businesses to switching stations) in an average-size, urban area accounts for between 56 percent and 67 percent of the cost of a local exchange network.

<sup>143</sup>Bridger M. Mitchell, *Incremental Costs of Telephone Access and Local Use* (Santa Monica, CA: The RAND Corporation, 1990).

issue further and weigh its implications for the U.S. economy when considering deregulation of the local exchange.

If Congress undertakes deregulatory measures that do not promote the highest level of fair competition<sup>144</sup>, the United States may be left with an inefficient market structure that sustains higher prices than other, properly deregulated markets (e.g. the United Kingdom) and thereby hinders U.S. international competitiveness. Worse yet, without any deregulation (and particularly if foreign countries deregulate their own markets) the United States risks losing its competitive edge altogether. It is therefore imperative that the U.S. Congress pass comprehensive deregulation legislation as soon as possible.

## **B. Opening Foreign Markets**

Since foreign countries are not committed to permitting foreign participation in telecom markets, the U.S. government must adopt an aggressive, incentive-based strategy to persuade foreign countries to open their telecom services markets. The most effective strategy to increase foreign opportunities for U.S. firms incorporates three policy initiatives:

- Aggressively pursue a comprehensive liberalization agreement in the General Agreement on Trade in Services (GATS) negotiations.
- Create incentives for foreign countries to liberalize by considering the relative openness of foreign markets when evaluating foreign carrier petitions to enter the U.S. market.
- Aggressively pursue bilateral and smaller multilateral agreements with like-minded countries.

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<sup>144</sup>In order to promote fair competition in the domestic market, Congress must address and resolve many other contentious issues. They include interconnection, network standards, local number portability, conduits and right of ways, unbundling, ending line-of-business restrictions, universal service, and service resale. These issues, however, are beyond the scope of this study.

## 1. Multilateral Negotiations

The United States government is currently engaged in negotiating a multilateral telecom services market opening agreement under the General Agreement on Trade in Services (GATS).<sup>145</sup> By allowing the United States to avoid trade friction with its trading partners, an international agreement on trade in telecom services is by far the most desirable solution to the problem of closed markets and discriminatory policies. Therefore, concluding a successful GATS negotiation should be the first priority of the U.S. government telecom market opening strategy.<sup>146</sup>

The United States must take a strong position in the GATS negotiation to ensure that U.S. firms are allowed to compete on a level playing field in foreign markets. Four issues must be addressed: determining the minimum principles for a successful GATS, establishing a reasonable time frame for market liberalization, defining a critical mass of countries, and reviewing U.S. policies on foreign ownership limits and dominant carrier status.

### a. Minimum Principles of a Strong GATS

Before the United States agrees to accept commitments in any telecom services sectors that would further open the United States to foreign participants, foreign countries must agree to certain basic principles ensuring that they will no longer exclude, or discriminate against, U.S. firms:

- *Countries must permit foreign firms to operate as both resellers and facilities-based operators in the basic telecom services market.*

<sup>145</sup>The GATS provisions can be divided into two parts: the rules that apply generally and rules that apply when a market opening commitment is scheduled. Rules that apply generally affect all service sectors regardless of whether a nation has scheduled a commitment. General rules include transparency and most favored nation treatment. The GATS lays down another set of rules which are only enforceable when a nation makes a specific commitment to open part of its market. These rules cover national treatment and the market access of foreign firms. "Once a nation has listed a particular sector or subsector in its schedule of commitments, it is bound automatically to the principles of national treatment and market access unless it otherwise lists reservations to these provisions in its schedule." A nation must either eliminate the above-mentioned barriers or list them as 'reservations' which exempts that nation. For example, a nation may take an exemption from MFN treatment or decide to limit the number of suppliers in a market when making a commitment in telecommunications services.

<sup>146</sup>The United States proposed a comprehensive liberalization policy during the Uruguay Round of the GATT. However, a satisfactory agreement was not reached.

It is vital for countries to allow foreign firms to operate as both resellers and facilities-based operators. Countries that restrict foreign firms to resale operations limit the ability of foreign firms to operate profitably and to sustain growth, and therefore institutionalize the position of the dominant, domestic carrier.<sup>147</sup>

- *Countries must guarantee that foreign firms will have access to the public network. Interconnection tariffs must be non-discriminatory, cost-based, and publicly disclosed.*

An equally important market access issue is interconnection -- the ways in which a firm is allowed to interact with the public network. Access to the public network is essential for new entrants to compete in any country's telecom services market. Consider, for example, a U.S. market in which the Baby Bells were permitted to provide long distance service while still holding a monopoly in the local exchange. If the Baby Bells charged long distance companies higher rates than they charged themselves, the long distance companies would be placed at a cost disadvantage. Long distance companies could potentially lose their customer base, and the Baby Bells could seize control of the U.S. telecom market.

Some countries have argued that interconnection is a private issue and that mandating interconnection is not a legitimate role of government. Considering that most countries have owned and operated these telecom firms, and protected their entrenched position, it seems inane to think that governments now have no role to play in promoting fair

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<sup>147</sup>Reselling is an effective way to penetrate a market but has limited profitability potential. Resellers, by definition, use the lines and facilities of another carrier and then resell services over those lines to customers. The reseller pays to the facilities-based carrier a fee which in most cases is slightly above the facilities-based carrier's costs. When the reseller competes with a dominant carrier (in most cases the former PTO) it must offer its services at a lower price than the dominant carrier to entice people to switch carriers, and thereby operates at a smaller profit margin than the entrenched carrier. The facilities-based carrier can, at any time, underprice the resellers and force them out of the market. The tenuous market position is only sustainable as long as the PTO allows them to remain in the market. Furthermore, resellers are automatically restricted by the capacity of the facilities-based carrier. If only 20 percent of a facilities-based operator's lines are available to resellers, then resellers face a ceiling on the number of services which they can provide. When resellers reach the ceiling, future growth depends upon their ability to become competitive facilities-based operators. In order for U.S. firms to be successful in foreign markets, nations must allow both resale and facilities-based competition.

and competitive markets. Our trading partners must ensure that U.S. firms are able to interconnect with the public network in a reasonable and non-discriminatory manner. Tariff rates should be publicly quoted to ensure that firms follow these principles.

- *Countries must ensure that foreign ownership is not restricted by either quantitative limits or mandatory joint ventures.*

Although unrestricted foreign ownership is one of the six general principles of market access applied to countries who make GATS commitments in a telecom sector, many countries will attempt to secure reservations and prevent U.S. firms from establishing wholly-owned subsidiaries. It seems very unlikely that countries who have relied on their telecom firms to subsidize other services will completely relinquish their investment interests in the PTOs. The United States should agree that governments may maintain a "golden share" of their PTOs, but those countries must ensure that the PTO will receive no special treatment or privileges from the relationship.

- *Foreign countries must ensure that their carriers will not use profits gained from other ventures to cross-subsidize their telecom services ventures.*

The problem of cross-subsidization must also be addressed. It is possible that former PTOs could subsidize certain telecom services with the monopoly rents collected from other ventures, in an effort to drive out efficient foreign competitors. The most precarious issue related to subsidization is how to divide universal service charges fairly among competing carriers. Universal service arrangements, which will undoubtedly differ considerably from country to country, must not advantage the former monopoly. This would place U.S. and other foreign firms at a severe disadvantage in servicing these markets and would violate accepted fair market principles.

- *Customers must be guaranteed equal access to foreign and domestic telecom services providers.*

It will be impossible for foreign firms to compete with former monopolies if customers are not given identical access to all firms. Two access issues should be addressed by the U.S. government in these negotiations: maintaining phone numbers when switching carriers, and dialing different codes to access different carriers. If customers are required to change their phone number each time they change telephone carriers, new entrants to foreign markets will have little chance to secure significant market share. Similarly, new entrants will not thrive if their customers are required to dial special codes in order to access their telecom systems while dominant firm customers have no code requirement and retain the right to all uncoded or default traffic.

- *Foreign countries must subscribe to the principle of interoperability.*

Countries must allow foreign firms who use equipment differing from the national standard (but still compatible) to interconnect with the public switched network without penalty. Many of the restrictions placed on equipment is aimed at protecting domestic manufacturers under the guise of maintaining "network integrity".

#### **b. Determining Reasonable Time Frames for Foreign Liberalization**

It is unrealistic for the United States to expect its trading partners to agree to these market opening commitments without some period of adjustment. The United States should acknowledge this fact and accommodate requests for delays when justified. The time frame for meeting all commitments must not exceed, in any case, four years for developing countries,<sup>148</sup> and in most cases should not exceed two years for developed and newly-industrialized countries. These time frames should take into account the condition of the country's telecom infrastructure and the initiatives undertaken by the government to deregulate their market. The United States, by offering countries enough time to deregulate

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<sup>148</sup>Based on the U.K., U.S. and Japanese deregulation programs, six years is more than enough time for foreign nations to corporatize, privatize, upgrade existing networks, and introduce domestic competition.

completely and introduce domestic market forces, will persuade a greater number of countries to make stronger commitments.

#### c. Defining a Critical Mass of Countries

Before the United States commits to the principles listed above, it must secure similar commitments from a minimum, "critical mass" of countries. There are two groups of countries which must agree to market opening commitments -- developed countries with strong (i.e. wealthy, large, or international) dominant carriers, and developing or newly-industrialized countries with growing markets and carriers.

Because closed foreign markets afford foreign firms a guaranteed piece of the global services market, it is important to secure market opening commitments in both developed, newly-industrialized, and developing countries. The United States needs to guard against cross-subsidization by large, established foreign firms. If firms with institutionalized or virtual monopolies in their closed home market are gaining access to the U.S. market, the foreign carrier can cross-subsidize their U.S. operations and "dump" services. Countries which fit this description include Japan, Canada, Australia, New Zealand, all of the European Union member states, and the members of the European Free Trade Association. It must also be remembered that firms in developing and newly industrialized countries (many of which are upgrading their networks) could also pose a threat to fair market competition in the United States. These countries include Mexico, South Korea, Malaysia, Singapore, Taiwan, Chile, and Thailand.

#### d. Reviewing Section 310 and Dominant Carrier Classification

*The U.S. Foreign Ownership Restriction -- Section 310 of the 1934 Communications Act*  
The United States will undoubtedly be asked by its trading partners to abandon Section 310 of the 1934 Communications Act that limits foreign ownership to 25 percent and is in direct conflict with the GATS rules concerning market access.<sup>149</sup>

Opponents of this provision state that the limit on foreign direct investment deprives U.S. firms of much-needed capital that many would be unable to acquire in U.S. financial markets, and thereby, lessens competitive pressures.

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<sup>149</sup>The ownership restriction is also contradictory to the principles of the OECD Code of Liberalization of Capital Movements from which the United States had to take a waiver.

However, these consequences of maintaining Section 310 are not as severe as some analysts contend, for three reasons. First, no U.S. carrier has shown any inability to raise needed capital in the U.S. capital markets. Second, the FCC has the authority to waive this provision, and has done so on numerous occasions. The Commission examines the needs of the U.S. carrier (including its ability to secure other funding), the relative openness of the foreigner's home market, and the acquisition's impact on the U.S. telecom market (i.e. whether asymmetrical market access problems will arise). This review balances the interests of the U.S. carrier with the impact of the deal on the U.S. economy and telecom services market. Third, there are a multitude of domestic firms interested in entering the telecom services market to promote fierce competition. The long distance market is a perfect example -- over 500 firms compete for long distance service customers with the current foreign ownership restriction. There is no reason to believe, once other parts of the U.S. market are deregulated, that competitive pressures will be substantially limited by restricted foreign ownership.

Maintaining the foreign ownership limit, and offering to rescind it in return for reciprocal market access, provides an incentive to foreign countries. The U.S. is the largest market in the world for telecom services, and foreign firms who wish to compete in global markets must have a presence, either through direct investment or alliances, in the United States. If the U.S. government unilaterally abandons its foreign ownership limitation, the United States, which has very few incentives to offer its trading partners, due to relatively few restraints on foreign firm access, will have even less with which to bargain. It is logical, therefore, for the United States to maintain the foreign ownership restriction if the GATS negotiations fail to produce a strong telecom services agreement.

#### *Dominant Carrier Classification*

The U.S. government should maintain the dominant carrier classification to protect the domestic market from unfair competition, but should continue to resist efforts to apply the classification simply to impede foreign entry and avoid fair market competition. Dominant carrier status is a necessary regulatory tool to prevent foreign monopoly providers from abusing their market power to disadvantage other firms in the U.S. market. The United States must realize that, although many countries are introducing competition in what were once monopoly markets, many of these foreign monopolies will not face substantial

market competition for some time, and will therefore continue to wield monopoly powers. The GATS fails to recognize this fact.

The GATS requires member countries to ensure that domestic monopoly providers who have affiliates in other countries do not abuse their home market power (which would allow the monopoly to act unfairly in foreign markets). However, the GATS fails to recognize the market power of dominant carriers after competition has been introduced.<sup>150</sup> Once a competitor to the monopoly is licensed, member countries are not required to monitor the actions of the ex-monopoly. For example, if the German basic telecom services market were liberalized completely and ten firms entered the German market to compete against Deutsche Telekom, the German government would no longer be obligated by the GATS to ensure that Deutsche Telekom not abuse its market power. The lack of substantial international rules, and the fact that many firms operate as monopolies or retain monopoly powers in foreign markets, are ample justification for maintaining precautionary regulations such as dominant carrier status. It is important to let the international community know that this rule is not a weapon to thwart foreign participation but a safeguard for U.S. consumers and all firms operating in the U.S. telecom market.

## 2. Creating Incentives

In order to maximize the probability of reaching an agreement, U.S. telecom policy must be incentive-based. The FCC should adopt a policy making comparable market access a key factor in their decision to grant or deny foreign entry to the U.S. market. This policy should not set rigid comparability standards effectively excluding all foreign firms from the U.S. market: the U.S. economy benefits when foreign telecom firms, operating in liberalized native telecom markets, compete in the U.S. market. Instead, the FCC should review a general list of market access issues when considering foreign petitions to enter the U.S. market. Such a policy will permit foreign firms with liberal home markets to compete in the United States while encouraging foreign nations to open their markets to U.S. firms.

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<sup>150</sup>Article VIII of the GATS which defines Member obligations for monopoly oversight applies to "cases of exclusive service suppliers where a Member authorizes a small number of service suppliers AND substantially prevents competition among those firms." (Emphasis added)

The benefits of this policy are threefold. First, the United States will have significantly greater leverage in international negotiations. The U.S. market is still the largest market in the world, and foreign firms wishing to provide global services to multinational firms must have a presence here. Second, this regulation will ensure that competition in the U.S. telecom services market remains fair. Foreign PTOs who accrue monopoly profits in their home markets will not be allowed to cross-subsidize foreign affiliates in the United States and undercut competitive firms. This standard will protect not only U.S. firms, but also foreign firms who do not benefit from protected home markets. Third, foreign firms will not be permitted to acquire greater economies of scale relative to U.S. firms as a result of asymmetrical market access -- i.e. restrictive foreign regulations will not be used to add to the competitiveness of foreign firms.

Opponents of a comparable access standard claim that the most significant problem is defining "equivalency". No two countries have the same regulatory regimes, and different countries allow competition in different telecom service markets. Some argue the proposal effectively imposes the U.S. regulatory regime on foreign countries, and determining comparable market access will take years of bureaucratic investigation and bickering which will further delay market access.

These problems need not exist. The key to making quick decisions on market comparability is determining the market access issues to review. The FCC should therefore quickly adopt an unambiguous list of criteria (such as those proposed earlier in this Chapter) to ensure that reviewing foreign license requests is fast and objective.

### **3. Multilateral/Bilateral Negotiations -- Beyond the GATS Framework**

If the GATS concludes unsuccessfully or proves fruitless after the original April 1996 deadline, the U.S. government should begin negotiating multilateral/bilateral agreements outside the privy of the GATS. The U.S. government should not allow the GATS negotiations to drag out past the original deadline without actively exploring other avenues to reach market

opening agreements. The longer foreign markets stay closed, the less the U.S. economy gains.

Under smaller multilateral/bilateral agreements, the firms from signatory countries would be granted greater access to the U.S. telecom market than firms from non-signatory countries -- i.e. the FCC would not review market access issues when considering a license application from a signatory country's firms. The FCC should also use its authority to waive Section 310 ownership restrictions. The firms of non-signatory countries would be required to submit to both the FCC market access evaluation and Section 310 stipulations.

Seeking a smaller multilateral agreement would allow the United States to expand market opening commitments while leaving the door open for future rounds of negotiating. If other countries became willing, at a future date, to make similar market opening commitments, the agreement could be expanded to include these countries.

Opponents have one primary objection to establishing smaller multilateral agreements outside the GATS: the United States would be forced to take an exemption to the most-favored-nation (MFN) principle. Some believe the United States should act as a role model for other countries, leading by example. This stance, it is argued, will show foreign countries the benefits of competition and result in foreign market liberalization. Taking an MFN exemption in basic telecom, opponents assert, will make it harder for the United States to convince its trading partners to adopt liberal market policies in telecom services as well as other service industries.

However, this generic, textbook analysis underestimates three factors -- the commitment of most countries to protect domestic providers, the vast opportunities in foreign markets, and the benefits open foreign markets would bring to U.S. firms and consumers. As shown in Chapter Four, not taking an aggressive, incentive-based position could cost U.S. firms, workers, and consumers tens of billions of dollars annually. In a time of runaway merchandise trade deficits and increased competition from newly developed countries, the United States simply cannot afford to pass up opportunities to expand exports. The benefits of securing smaller multilateral market opening agreements

outweigh the negative consequences, if any, incurred by an MFN exemption. The various U.S. policy options, their pros and cons, are summarized in Table 5.2.

**Table 5.2: U.S. Policy Options.** Source: Economic Strategy Institute.

Policy Option	Pros of Policy Option	Cons of Policy Option
<p><i>Continuing the Present Policy</i>  The United States can advocate foreign market liberalization while allowing foreign firms to enter freely and compete in the domestic market.</p>	<ul style="list-style-type: none"> <li>• Would reinforce the U.S. position as the world's leading advocate of free trade. Some countries might follow the U.S. example.</li> </ul>	<ul style="list-style-type: none"> <li>• If asymmetrical market access continued to exist, foreign firms would use profits made in the home market to "dump" in the U.S. market.</li> <li>• U.S. firms would not achieve the same economies of scale as their international competitors and therefore would be less competitive.</li> <li>• U.S. firms would be denied billions of dollars in revenue from foreign markets.</li> </ul>

Policy Option	Pros of Policy Option	Cons of Policy Option
<p><i>Securing Multilateral Agreements</i></p> <p>The United States can pursue a multilateral agreement in the GATS negotiation which incorporates the previously mentioned principles.</p>	<ul style="list-style-type: none"> <li>• U.S. firms would be given the chance to compete for the lucrative opportunities emerging in foreign markets on a level playing field with former PTOs.</li> <li>• Foreign firms would not "dump" services into the U.S. market.</li> <li>• Foreign firms would not acquire greater economies of scale relative to U.S. firms, due to asymmetrical market access.</li> </ul>	<ul style="list-style-type: none"> <li>• None</li> </ul>

Policy Option	Pros of Policy Option	Cons of Policy Option
<p><i>Pursuing Smaller Multilateral and Bilateral Agreements</i></p> <p>If multilateral negotiations fail to conclude successfully, the United States can seek commitments from other liberalization-minded countries.</p>	<ul style="list-style-type: none"> <li>• U.S. firms would gain greater access to some foreign markets which otherwise would be closed.</li> <li>• Foreign firms would not be permitted to "dump" services into the U.S. market.</li> <li>• Intense pressure would be placed on foreign countries to open their markets.</li> <li>• Foreign firms would not acquire greater economies of scale relative to U.S. firms, due to asymmetrical market access.</li> </ul>	<ul style="list-style-type: none"> <li>• Taking an MFN exemption might tarnish the country's image as the leading advocate of free trade.</li> <li>• Many opportunities in foreign markets would still be out of U.S. firm reach.</li> </ul>

## C. The Accounting Rate System

Since competition, in the vast majority of foreign nations, will be realized in the near future, the U.S. government must pursue an aggressive policy to lower the above-cost fees paid to foreign carriers for connecting international traffic. This policy should consist of two simultaneous efforts -- negotiating the replacement of the accounting rate system, and strong advocacy of lower rates under the existing system.

### 1. A New International Settlements System

The United States should begin negotiating for the immediate elimination of the accounting rate system and the institution of a cost-based, transparent, non-

discriminatory access charge.<sup>151</sup> The access charge model separates the cost of transmitting an international call into three components based on geographic boundaries. First, a firm in the originating country carries the call through its network to the country's border (more precisely, to the international switching office). Secondly, the call is either transmitted via an underwater submarine cable to the destination country or fed directly into the foreign country's international exchange if the countries are landlocked. Finally, a foreign firm carries the signal through its network to the final destination. Dividing transmission costs in this manner allows nations to identify specific cost factors.

While the costs of the second leg are influenced by international factors, the costs incurred in the first and third legs of transmission are not. Costs of the first and third transmission leg vary by domestic distance factors. The cost of connecting a call from New York to Buffalo is less than the costs incurred connecting a New York City to San Francisco call. Therefore, once an international call reaches a foreign border, the cost of completing that call is not sensitive to the call's origination point. International transmission costs, the second leg, vary by the country of origin, although the costs are much less sensitive than domestic long distance traffic.<sup>152</sup>

A hypothetical example employing Figure 5.1 illustrates this point. Two persons are calling Perth, Australia. Person A is calling from New York and Person B from Tokyo. Both Persons A and B are charged for the transmission of their signal through the domestic network to their country's boundary. The cost of completing this leg of the transmission may differ for Persons A and B because Person A's call must be transmitted 3,000 miles across the United States while Person B's call only goes to a facility in southern Japan. The next leg of the transmission is carrying the call via submarine cables to Sidney, Australia, where the cable connects into the Australian network. Since the United States is farther from Australia than Japan, we would expect Person A's costs in the second leg of transmission also to be higher. In the third leg of the transmission, both Person A and Person B's call travel from Sidney to Perth through the Australia long

<sup>151</sup>This alternative has been proposed by the OECD's Working Party on Telecommunication and Information Services Policies in *International Telecommunication Pricing Practices and Principles: A Progress Review* (to be released).

<sup>152</sup>Transnational transmission costs are only marginally distance sensitive when submarine cables are employed, and even less distance sensitive when traffic is transmitted via satellite.

distance company's network. The cost of this leg of the transmission (from Sidney to Perth) are equal for both Person A and B's call and, in fact, are equal for any call regardless of country of origin.

Under the present accounting rate system, the prices charged for the completion of an international call are negotiated bilaterally, and are dependent upon the country of origin<sup>153</sup>; and usually U.S. consumers are charged more than customers in other countries. Under the access charge model, international calls destined for the same location in a country (which enter the network from the same location) are charged the same traffic access charge, regardless of where the call originates. Therefore, a traffic access charge is inherently less discriminatory than an accounting rate.

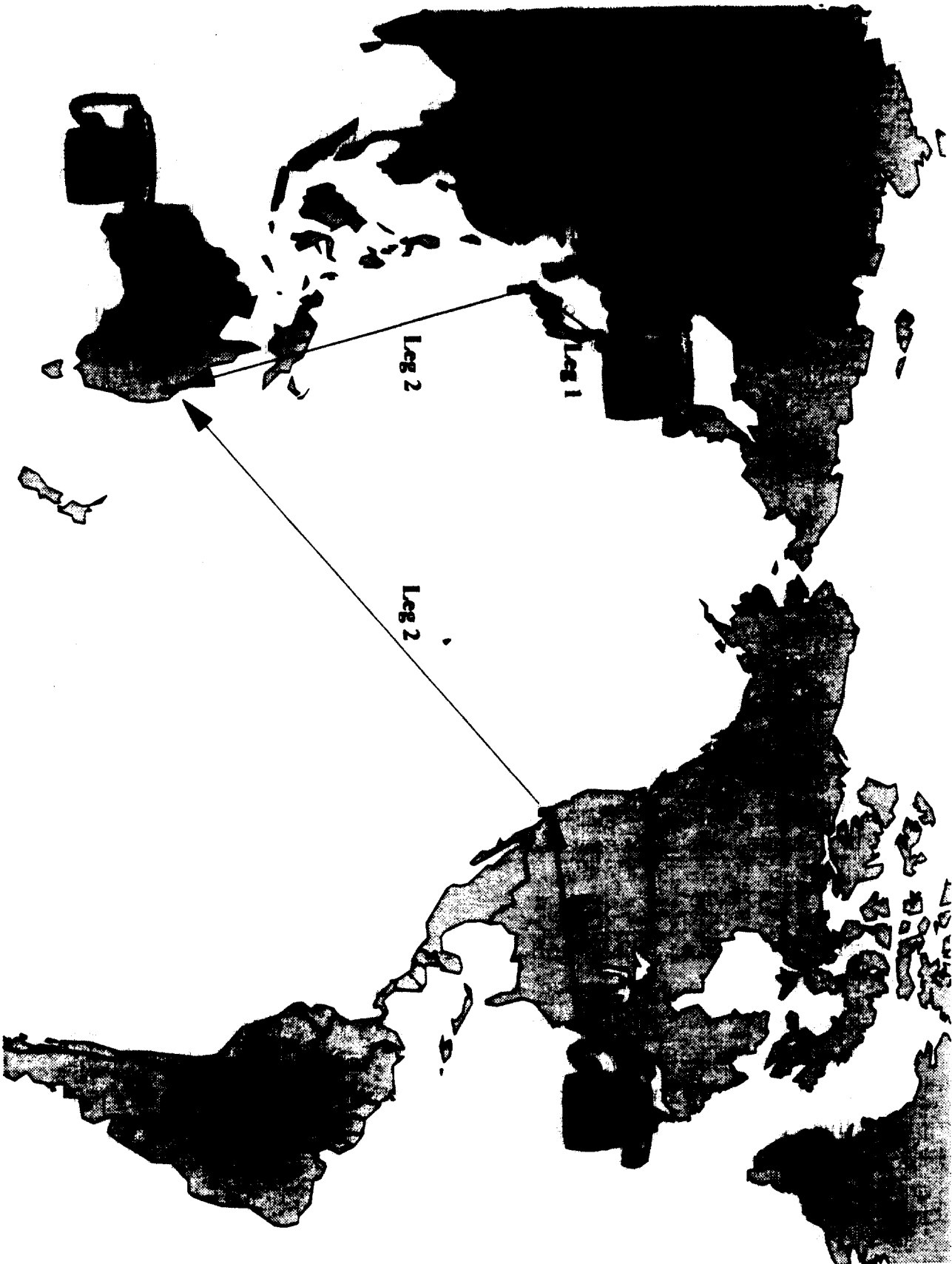
In order to ensure non-discrimination, the access charge must be cost-based and transparent. The United States should advocate that all international telecom services providers make public their access charge and supply an accounting justification for these charges to all other signatories.<sup>154</sup> The costs of terminating the call under the access charge system should closely correspond to the cost of providing domestic service from the international switching office to the call destination. In the example above, the access charge should mirror the cost of a domestic long distance call from Sidney to Perth plus the marginal cost incurred by the international switching office. This procedure is essential for creating a fair, cost-based, and transparent international service agreement system.

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<sup>153</sup>The accounting rate system recognizes two components of an international call by randomly dividing the submarine cable in half and 'handing off' the call at this midpoint to the foreign carrier. This artificial construct allows foreign nations to argue that differential accounting rates based on nation of origin are justified when in actuality the costs of transmission through submarine cables are minuscule.

<sup>154</sup>This may also require the accounting separation of telecommunications operations from other businesses (particularly for PTOs).

Figure 5.1: Model of A New International Service Operating Agreement.



## 2. Advocating Cost-Based, Non-Discriminatory Accounting Rates

While negotiating for a new international settlement system, the FCC should adopt a policy that increases pressure on foreign monopolies and governments to negotiate cost-based, non-discriminatory accounting rates. The main problem in advocating non-discrimination and cost-based accounting rates is determining costs and comparing accounting rates -- the United States is the only nation which requires the public disclosure of all international accounting rates. The FCC should therefore request that foreign carriers seeking permission to compete in the U.S. market disclose all of their current and historical accounting rates with other countries. Foreign monopolies petitioning to expand their current activities in the U.S. market should also be asked to submit this information. If a petitioning firm does not submit accounting rate information, the FCC should assume that the foreign firm is discriminating against U.S. consumers.

In the absence of international cost data, the FCC should employ surrogate cost measures as a rough approximation of a cost-based accounting rates. The FCC should calculate these approximations based on relevant international transmission costs and long distance traffic within specific countries. These approximations should not be viewed as an ideal accounting rate charge, and the FCC should only advocate the reduction of accounting rates consistent with this rough approximation. Admittedly, a surrogate-based policy is far from ideal, since it does not guarantee cost-based accounting rates or guard against discriminatory pricing. This policy should therefore only be effective in the interim, while the above-mentioned international settlement system is negotiated.

If foreign firms refuse to re-negotiate accounting rates when strong evidence suggests that discrimination or above-cost-based accounting rates exist, the FCC should consider taking stronger action. In 1991 the FCC tentatively concluded that they had the authority "to determine and prescribe just and reasonable accounting rates".<sup>155</sup> The FCC should investigate and determine if in fact they have this authority. This policy tool should be used only when the private accounting rate negotiations have become exhausted and evidence clearly points

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<sup>155</sup>FCC Docket No. 90-337, Report and Order, May 9, 1991, p21.

to discrimination or above-cost rates. Those who object to government intervention into "private" negotiations should remember that most foreign firms are public entities or retain government-sanctioned monopoly status. In essence, many accounting rates currently are being dictated by foreign governments who extract monopoly profits from U.S. consumers. Therefore, U.S. government intervention in these negotiations to protect the interest of American consumers is both reasonable and sensible.

## **Conclusion**

The telecommunications services industry is one of the most vital industries in the U.S. economy. As a country, we cannot allow this industry to become less efficient, less innovative, or less competitive. The U.S. government has always played a role in shaping this industry and ensuring that U.S. businesses and consumers enjoy the best telecommunications services in the world -- from mandating universal service to breaking up AT&T. It is now crucial for the government to reshape the industry again, to break down remaining inefficient, domestic market structures and to open foreign markets for U.S. telecommunications firms. If this action is delayed, or never taken, the United States will risk losing its world-class efficiency and competitive advantage in yet another key industry, and every American citizen will bear the dire consequences.

